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Dade County, Fla. Enters Step-Up Swap with GB Derivative

By Sharon R. King

Dade County, Fla., has become the first municipality to enter into a so-called step-up swap agreement, according to the firm that arranged the swap.

In mid-September, the Dade County Water and Sewer Authority entered into a \$40 million, seven-year fixed-to-floating interest rate swap with GB Derivative Products Co.

A unique feature of the swap is that while the county pays a floating rate of interest to the swap provider, the fixed rate of interest it receives gradually increases over the life of the transaction.

Generally, a fixed-to-floating-rate swap is used by issuers to convert debt service on fixed-rate bonds to a floating rate.

The issuer receives a constant fixed rate of interest for the life of the swap. In exchange, the municipality pays a floating rate, based on the Public Securities Association's municipal swap index.

However, the issuer runs the risk that the floating rate it pays may exceed the fixed rate that it receives on its debt.

With the step-up structure, the fixed rate the issuer receives increases to a predetermined level each year during the life of the swap. The structure acts as a hedge and greatly reduces that chance that an issuer will have to make net payments to its swap counterparty in the event that interest rates rise over the life of the swap, GB Derivative officials said.

Initially, Dade County will receive a fixed rate of about 3.5%, slightly lower than the average rate available on a seven-year swap, said Pandu Gururaj, a senior vice president at WR Lazard & Co., the county's financial adviser. But at the end of the swap, the fixed rate the county receives will be higher than 7%, or well above the average available on such transactions, Gururaj said.

Dade County officials were not available to comment on the swap transaction.

The structure has been more commonly used on taxable deals, where the issuance of step-up bonds is coupled with a step-up interest rate swap, market sources said.

GB Derivative Products is an affiliate of Grigsby Brandford & Co., jointly owned by its managing partners and Grigsby Brandford. The firm, created earlier this year, is considered to be the first minority-owned firm able to act as a principal on a municipal swap transaction.

The structure was developed as a response to issuers' concerns about rising interest rates, said J. Donald Rice, president and chief executive officer of GB Derivative.

Issuers wanted a product to reduce the possibility of losses any one year over the life of the swaps, Rice said.

"We're doing innovative transactions in a way that solves problems for our clients," Rice said.

In a more common swap, issuers generally convert variable-rate debt into fixed-rate debt. Such a swap would allow the municipality to make fixed-rate debt service payments. In return, the municipality would receive variable-rate payments from the swap counterparty.

Use of fixed-to-floating rate swaps is more limited because of some municipalities' concerns about rising interest rates and some prohibitions against converting fixed-rate debt to variable-rate debt, market sources said.

At a time when derivative issuance has been declining, Dade County stands out for its use of some innovative derivative deals this year.

In January, Smith Barney Inc. served as bookrunning manager on a \$431.7 million Dade County water and sewer revenue bond offering. The financing included the largest long-dated swap ever done by AIG Financial Products, which is credited with creating the structure.

Although Dade County officials decided to enter into the step-up swap because they believe interest rates are going to continue rising, the step-up structure could be advantageous in either a rising or a falling interest-rate environment, WR Lazard's Gururaj said.